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C O N F I D E N T I A L SECTION 01 OF 02 MOSCOW 000980

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DEPT FOR EUR DAS KRAMER AND EUR/RUS WARLICK
DEPT FOR EB DAS SIMONS AND EB/ESC/IEC GALLOGLY/GARVERICK
DOE FOR HARBERT/EKIMOFF
DOC FOR 4231/IEP/EUR/JBROUGHER
NSC FOR KLECHESKI AND MCKIBBEN

E.O. 12958: DECL: 03/07/2017
TAGS: EPET ENRG ECON PREL RS
SUBJECT: RUSSIAN ENERGY: PROSPECTS FOR DEALS IN THE SECTOR

REF: A. 03/05/07 GUHA - EMBASSY MOSCOW EMAIL

¶B. MOSCOW 875

Classified By: Amb. William J. Burns. Reasons 1.4 (b/d).

¶1. (C) Summary. Despite increased GOR control over the sector, U.S. majors are involved in several high-profile deals and below-the-radar deals are becoming more common as well. Russia will need western expertise -- most urgently on the gas side -- as it moves to exploit the offshore and the eastern half of the country. Shtokman is once again in play as well. The way forward will be bumpy, of course -- CPC expansion remains elusive and Gazprom's muscling into Sakhalin-2 worried many. Nevertheless, our companies tell us that they can work within the new "rules" governing the sector -- minority stakes with Gazprom or Rosneft holding the keys to the kingdom. They note that Russia is a long-term play and they believe patience will pay off. End Summary
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MORE THAN A TOEHOLD

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¶2. (C) While certainly not fulfilling the promise that existed just four years ago, foreign investment in the Russian energy sector is still significant. All three U.S. majors have made or inked sizable investments here. The two billion dollars ExxonMobil put into Sakhalin-1 brought the company to its targeted 250,000 b/d two months ago. (NB: This project accounts for nearly all of the increase in Russian oil output in recent months.) Chevron says its recently signed JV with GazpromNeft is doing well and that they intend to partner on more than just the current one or two licenses in West Siberia. ConocoPhillips has by now invested $8 billion in Lukoil. The two companies' JV is also quite active in the Timan-Pechora region and is looking to expand refining and third country cooperation. Smaller companies like Amerada Hess (with an active and growing investment) and Harvest Natural Resources (with a putative gas deal in the offing) are finding that working "below-the-radar" pays off.
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THE FUTURE

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¶3. (C) Russia presents an opportunity for our companies as the country struggles to find new sources of gas (Ref B). Gazprom is already relying more heavily on independent gas producers and Russian oil companies' to meet demand, and

foreign companies are being brought into the mix as well. The planned Harvest deal, which involves providing gas to an area near Volgograd, may be a model for future western participation in Russian domestic gas supply. Gazprom has also acknowledged that it needs Shell's expertise in Sakhalin 2 and western technology in the offshore.

¶4. (C) The same promise holds true on the oil side because of the uninviting geography -- and consequent high capital costs -- of some of the newest basins in East Siberia and offshore. Often lost in the shuffle is the land-office business service companies like Halliburton and Schlumberger are doing here. They will likely be among the main beneficiaries of Russia's foray into regions that require ever more sophisticated recovery techniques. Growing production is still state policy, and by continuing to fiddle with improvements to taxation, licensing, and transportation routes the GOR may at least keep enough in investment pipeline to prevent oil production from falling -- and as long as investment flows, our service companies stand to benefit.

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SHTOKMAN IS BACK

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¶5. (C) Shtokman appears to have resurfaced within Gazprom as an urgent priority. Chevron's Russia chief Ian MacDonald told EUR/RUS (Ref A) that Gazprom invited the "short-list" companies to bid by April 1 on a re-vamped project to develop Shtokman. ConocoPhillips' CEO Mulva confirmed to the Ambassador March 7 that they had received a similar invitation. Gazprom intends to announce the composition of the consortium as early as May 1. The field would initially produce 23 bcm/year, with half of the flow going into the Nord Stream pipeline to Germany and the other half to an LNG

facility in Murmansk. Companies complain that the structure of the deal leaves them with significant price and corporate management risks, and both firms will decide whether to bid over the next week. Mulva told the Ambassador Gazprom is negotiating much more professionally this time around and offering terms much like a PSA that will result in some version of "bookable" value.

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PROBLEMS REMAIN

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¶6. (C) Concerns, of course, persist about doing business here. The stalled negotiations over CPC expansion shows how entrenched interests can affect important projects. Shell's run-in with Gazprom on Sakhalin-2, especially the use of environmental regulations to muscle the Russian firm into the project, is the other prominent example in the energy sector. Further, the long-stalled Subsoil Law (both a new law and amendments to the existing one) mean that Russia is no closer to creating something that resembles a clarified and graft-free licensing regime. High tax rates on oil (in the face of climbing costs) have led many companies to pour money into refining instead of upstream growth.

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STILL IN IT FOR THE LONG HAUL

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¶7. (C) Nevertheless, company reps consistently tell us that they are here for the long-haul and are willing to play under the Russian "ground rules." They know that they will be consigned to a minority stake (albeit in huge projects) but are comfortable with that as long as they have a check on important corporate governance decisions such as budgeting and contracting. Some have told us that the Russians seem willing to allow such a "dual key" system as long as the Russian company "owns/controls" the reserves. Also, they also recognize that either Gazprom or Rosneft are the gatekeepers to the sector now and all are actively cultivating these two state-controlled companies.

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COMMENT

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¶8. (C) Patience and perseverance are the watchwords for our companies. They recognize that Russia is a long-term play and one that cannot be ignored. Some companies have decided to fly under the radar (Amerada, Harvest, and likely others soon), while others (the supermajors) have adjusted to the new realities of doing big deals here. The Russian oil and gas sector will need tens of billions of dollars over the next decades (some have estimated it at $150-200 billion). Our companies are banking on the fact that the GOR and the Russian industry will, in time, realize that it simply does not have that kind of capital and certainly does not have the project management skills to take on what are sure to be some of the most difficult development projects anywhere. Making our companies the partners of choice will require our continued efforts to encourage an environment in which deals can flourish and in which western business best practices and ethos slowly permeate Russia.
BURNS